

## Federal Energy Legislation

Legislation is currently under consideration in the U.S. Congress that would have a significant impact on the energy sector of the U.S. economy. The House of Representatives has passed a bill that, among other things, would expand FERC's jurisdiction over public power organizations, including Bonneville. The Senate Energy Committee has reported a bill that also provides greater FERC jurisdiction over public power systems. However, other features of the Senate bill would limit the ability of FERC to implement standard market design as proposed in the original draft rule. Final action on the Senate bill is expected by late July 2003. A conference committee is likely to be required in order to resolve differences between the House and Senate bills. The Department cannot predict the outcome of the legislative process or the ultimate impact of federal energy legislation on the Department's operations and finances.

## RECENT DEVELOPMENTS AFFECTING THE DEPARTMENT

In 2000 and 2001, electric utilities in the western United States, including the Department, were subject to a number of unprecedented developments that had severe negative effects on their financial results. Efforts to restructure the electric utility industry in the State of California created turbulence in wholesale markets for electricity and natural gas. Wholesale prices rose dramatically throughout the western region. At the same time, severe drought conditions in the Northwest required the Department to rely more heavily on the wholesale market in order to meet the demand for electricity. As a result, the Department incurred net costs in excess of \$550 million purchasing power in the wholesale market in 2000 and 2001, more than ten times the amount assumed in its financial plan.

In response to this combination of events, the Department took a number of actions in 2001 and 2002 to deal with the impact of its unexpectedly high power costs.

- (i) The Department requested, and the City Council granted, four separate rate increases in 2001. The cumulative effect of these actions was an increase of 57 percent in average system rates. See "The Department—Retail Rates."
- (ii) The City Council authorized the Department to pass through to its retail customers the financial impacts of changes in power rates charged by Bonneville without further City Council action. The Department's retail rates have been adjusted three times in response to changes in Bonneville rates. See "The Department—Retail Rates" and "Power Resources—Purchased Power Arrangements—The Bonneville Power Administration."
- (iii) The Department increased its target for conservation savings and carried out an intensive public information campaign to encourage customers to reduce their use of electricity. As a result of these efforts and in response to the increase in rates, consumption of electricity by retail customers in the Department's service area fell by 5.1 percent from 2000 to 2001, thereby reducing the need to buy power in the wholesale market.
- (iv) The Department obtained additional sources of power by signing a new contract with Bonneville effective October 1, 2001, and by contracting to purchase power from the Klamath Falls Cogeneration Project and the State Line Wind Project. With over 400 average MW of firm power available from these resources, the Department expects to have surplus power available even under critical water conditions for the next several years.
- (v) In 2002, the Department refinanced \$86.6 million of outstanding Parity Bonds and participated in the refinancing of \$66.1 million of bonds issued by the Boise-Kuna Irrigation District for the Lucky Peak Project. The Department pays all of the costs of the Lucky Peak Project under a purchased power contract and therefore will realize the benefits of the refinancing. Present value savings from these two bond issues totaled over \$10 million.

To finance its operating cash flow requirements in 2000 and 2001, the Department incurred short-term debt. In March 2001 the Department issued \$182.2 million of Revenue Anticipation Notes, which were paid in full at maturity in March 2003. A loan of up to \$110 million from the City's Cash Pool was authorized in

December 2001. In November 2002, the 2002 Notes were issued in the amount of \$125 million. The 2002 Notes will mature in November 2003.

In 2002, with rates at the levels to which they were raised in 2001 and with the return of more normal water conditions to the Northwest, the Department's financial results improved considerably. The Department generated net cash flow from operations of \$97 million in 2002, which was used to reduce its outstanding short-term debt. Favorable financial results have continued in 2003 in spite of water conditions that have not been as favorable as in 2002. The Department has reduced its operating and capital budgets to offset the effect of sub-normal water conditions on cash flow. Through May 31, 2003, the Department has recorded net income of \$26.7 million, compared with \$25.4 million in 2002.

In December 2001, the City Council adopted new financial policies which provide that rates will remain at their current levels (unless increased by the City Council or adjusted to pass through changes in Bonneville rates) until all short-term debt obligations have been repaid and cash balances in the Department's operating account have reached the level of \$30 million. The Department now projects that this point will be reached in the third quarter of 2004. Retail rates can then be set on the basis of new guidelines that give greater recognition to the increased level of risks that the Department faces, given current conditions in power markets. It is anticipated that when the new financial policies take effect in 2005, over 50 percent of the Department's future capital requirements will be financed from operating revenue.

### **Pending Litigation Before FERC**

In two cases currently before FERC, the City is seeking refunds of amounts paid for electricity. Both cases arose from FERC's investigation of the extremely high prices experienced in the California energy markets beginning in May 2000 and continuing into the summer of 2001, which led FERC to issue an order on July 25, 2001 (the "Order").

The Order required a hearing in one case to determine refunds in the California markets operated by the California Independent System Operator and the California Power Exchange. Hearings have been completed and post-hearings briefs submitted. The Order also required a hearing in the second case to determine whether refunds should be ordered for transactions in the Pacific Northwest markets. In September 2001, the administrative law judge issued proposed findings and preliminary recommendations stating that prices in the Northwest were not unreasonable or unjust and refunds should not be ordered. The City filed a brief urging FERC to reject the recommendations and to recognize that the unreasonable prices in California directly affected prices in the Pacific Northwest. Supplemental briefs and evidence were filed by the City and other parties in the wake of Enron's revelation of market manipulation strategies in California. However, on June 25, 2003, FERC issued an order denying refunds in the Pacific Northwest case. The City currently is preparing a motion for rehearing.

The City also is involved in other legal actions relating to the failure of the California Independent System Operator to pay the Department for power deliveries in the fall of 2000. Finally, the City has filed a request to intervene in a FERC investigation of companies that may have cooperated with Enron in transactions designed to adversely affect the California and West Coast markets.

None of these actions is expected to materially adversely affect the financial condition of the Department.

## **POWER RESOURCES**

### **Overview of Resources**

The Department typically meets the majority of its energy requirements from its own power resources. These include four large and three small hydroelectric facilities which generate 7,117,981 MWh of energy, about 49 percent of the energy available to the Department from its owned and contracted resources, under average water conditions. Output from the Department's hydroelectric plants can vary significantly from year to year due to the variability of water conditions. In calendar year 1997, when water conditions were exceptionally good, hydroelectric output totaled 8,346,762 MWh. Under the drought conditions of calendar year 2001,